Testimony of

Dr. James Newsome, CEO

New York Mercantile Exchange, Inc.

Committee on Agriculture, Nutrition and Forestry

United States House of Representatives

April 27, 2006

Mr. Chairman and members of the Committee, my name is Jim Newsome and I am the CEO of the New York Mercantile Exchange (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. We have been in the business for 135 years and are a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a contract market and as a clearing organization. On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the members of the Committee for the opportunity to participate in today's hearing on the futures market and gasoline prices.

INTRODUCTION

NYMEX provides an important economic benefit to the public by facilitating competitive price discovery and hedging. As the benchmark for energy prices around the world, trading on NYMEX is transparent, open and competitive and heavily regulated. Contrary to some beliefs, NYMEX does not set prices for commodities trading on the exchange. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts and, being price neutral, does not influence price movement. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and execute trades at competitively determined prices that best

reflect what market participants think prices will be in the future, given today's information.

There is a strong beneficial and interdependent relationship between the futures and the underlying physical commodity or "cash" markets. The primary motivation for using the futures market is to hedge against price risk in the cash market. Price volatility drives many into the futures markets. Many prudent business managers rely on the futures market to protect their business against price swings in the cash market.

Futures markets provide a reference point for use in executing off-exchange trades at competitively determined prices. An understanding of the NYMEX market, its pricing mechanism and the relationship between the futures price and the cash price will provide useful instruction and clarity to what is often perceived as an esoteric area of the broader financial marketplace.

OVERVIEW

Futures markets fulfill two primary functions: (1) They permit hedging, giving market participants the ability to shift price risk to others who have inverse risk profiles or who are willing to assume that risk for potential profit; and (2) They facilitate price discovery and market transparency. Transparency involves many factors, including: (1) continuous price reporting during the trading session that is disseminated on a real-time basis worldwide by various market data vendors; (2) daily reporting of trading volume and open interest; and (3) monthly reporting of deliveries against the futures contract.

Currently, NYMEX's core energy futures contracts trade by open outcry on the Exchange floor during the day and during the evening on NYMEX ACCESS®, our after-hours electronic trading platform. Soon, NYMEX will offer side-by-side floor trading

and electronic trading so that market participants will have the choice during the trading day between executing their orders on the trading floor or on the electronic screen. Open outcry transactions are executed in a transparent and competitive environment between NYMEX members who are registered futures industry professionals.

NYMEX's futures and options contracts are listed and traded by calendar month. For energy contracts, trading terminates in the month preceding the month of actual delivery of the underlying commodity (if positions are not offset and held through the termination of trading for that contract month). Consequently, the front or spot month listed for much of this month has been the May 2006 contract month. The daily settlement price for each contract month of a listed contract is calculated pursuant to Exchange rules. The rules governing the calculation of our settlement price reflect the business judgments exercised by Exchange officials.

By listing contracts that are traded in contract months listed out into the future, a common convention in the futures industry, our prices at all times reflect the collective consensus of the marketplace as to the future direction of commodity prices. By contrast, many cash markets of the underlying commodities for our products, such as for gasoline, are quoted and traded in the cash market as day-ahead products. Consequently, there can be at times significant differences between prices in our markets and prices in the day-ahead cash market.

NYMEX energy futures markets are highly liquid and transparent, representing the views and expectations of a wide variety of participants from every sector of the energy marketplace. Customers from around the globe can place buy and sell orders through brokers on the NYMEX trading floor. On behalf of the customers, buyers

announce their bids and sellers announce offers. The price agreed upon for sale of any futures contract trade is immediately transmitted to the Exchange's electronic price reporting system and to the news wires and information vendors who inform the world of accurate futures prices.

Price signals are the most efficient transmitters of economic information, telling us when supplies are short or in surplus, when demand is robust or wanting, or when we should take notice of longer-term trends. NYMEX futures markets are the messengers carrying this information from the energy industry to the public. The wide dissemination of futures prices generates competition in the establishment of current cash values for commodities.

GASOLINE

Gasoline is the largest refined product by volume sold in the United States and accounts for almost half of the national oil consumption. It is a highly diverse market, with hundreds of wholesale distributors and thousands of retail outlets, often making it subject to intense competition and price volatility.

NYMEX trades, among other things, New York Harbor leaded and unleaded regular gasoline futures contracts. The New York harbor gasoline futures contract trades in units of 42,000 gallons (1,000 barrels). It is based on delivery of petroleum products to terminals in the New York harbor, the major East Coast trading center for imports and domestic shipments, from refineries in the New York harbor area or from the Gulf Coast refining centers.

Average daily trading volume in these contracts has hit record levels in recent months and prices have been volatile. These market conditions reflect the basic market

fundamentals where there is an imbalance of supply and demand. Tight gasoline supplies due to lack of refinery capacity, compounded by the lingering impact of Hurricane Katrina, concerns about Mideast insecurity, and more recently the transition from methyl tertiary butyl ether (MTBE) to ethanol have driven prices upward dramatically in the cash and futures market.

NYMEX closely monitors the gasoline futures market and increases surveillance during periods of price volatility. To date, we have found that our markets are behaving rationally and that the market participants acted responsibly in their futures and options trading. More specifically, we have seen no evidence to date to suggest that the recent price rises in gasoline futures being traded on our markets are attributable to violative activity.

MARKET ANALYSIS

NYMEX staff monitors the supply and demand fundamentals in the underlying cash market to ensure that NYMEX futures prices are consistent with broad, ongoing, cash market price movements and that there are no price distortions. Our analysis of the gasoline market has identified three key factors that are contributing to higher gasoline prices in the cash and futures market: 1) high crude oil prices; 2) MTBE phase-out; and 3) reduced refinery capacity.

High Crude Oil Prices

Crude oil is the main feedstock for gasoline production. Indeed, according to the Energy Information Administration, 59% of the price of the gasoline is attributable to the price of crude. Consequently, the strength in crude oil prices has led to higher gasoline prices. Last week, crude oil futures prices reached an all-time high of over $75.00 due to

continued concerns about Mideast security and rising global oil demand. Chart A (attached) reflects global crude oil prices using the front month NYMEX Light Sweet Crude Oil (WTI) futures and Brent Crude Oil futures prices.

MTBE Phase-Out

The gasoline market is currently in a difficult transition period due to the phase-out of MTBE, and the related transition to ethanol. As companies eliminate the use of MTBE and replace it with ethanol, gasoline refiners and importers must adjust their practices and systems. Ethanol, which is chemically different than MTBE, contains more volatile compounds than MTBE and, therefore, is harder to use in reformulated gasoline in the summertime. In addition, ethanol cannot be carried in the nation's pipeline system, and must be segregated from the wholesale distribution system until its addition at the truck rack. Finally, ethanol presents new demand and supply implications, which must be factored into the pricing of gasoline.

There is a level of uncertainty involved in this transition process as the marketplace adjusts to the new supply situation. This uncertainty typically leads to higher gasoline prices in the short term. Buyers and sellers have concerns about demand and supply fundamentals, and the higher costs are then passed on to consumers.

This transition process is now well underway but not yet completed, as the gasoline market begins to phase out MTBE-blended gasoline. Commencing after May 5, refiners will no longer be required by law to add oxygen to gasoline products. In addition, one price survey service, which collects and distributes surveys of prices of transactions in cash markets, will begin on May 1 to use Reformulated Gasoline blendstock (RBOB) as the anchor or reference point for gasoline transactions involving a

delivery point other than the New York Harbor. Consequently, most energy firms likely will continue to draw down and use up their reformulated gasoline inventory during the remainder of the month of May. Most market observers continue to believe that sometime this summer the RBOB product will largely replace reformulated gasoline as the predominant gasoline product in the cash market.

Chart B (attached) shows the wholesale price of ethanol and MTBE in the New York Harbor area. As you can see, ethanol prices are currently $1.00 per gallon higher than MTBE. This large price differential indicates the strength of ethanol demand as compared to MTBE. The ethanol is then added to RBOB, to make finished gasoline. NYMEX first listed RBOB gasoline futures for trading last October in anticipation of the phase-out of MTBE from the gasoline pool. Chart C (attached) shows prices for finished RFG (with MTBE included) and RBOB (before the addition of ethanol). The RBOB price is about 10 cents per gallon higher than finished RFG (with MTBE), and when the ethanol is added (at a 10% blend by volume) the finished ethanol-blended gasoline is priced even higher, at 15 cents higher than RFG with MTBE. This accounts for some of the recent price rise in gasoline.

Reduced Refinery Capacity

Even though no new gasoline refineries have been built in the US in several decades, this imbalance has been mitigated to some extent by higher efficiencies from existing plants, which have generally operated at a high rate of utilization in recent years. However, such a high utilization rate also means that when utilization rates are reduced for any reason, there will be an immediate impact on the availability of new supplies.

This year, the gasoline supplies have been constrained by lower refinery utilization rates due to heavy refinery maintenance. Some refineries reportedly had delayed maintenance work in the aftermath of Hurricane Katrina to ensure adequate gasoline supplies. Furthermore, additional refinery work is needed this year to comply with new low-sulfur requirements in diesel and gasoline. The end result is tighter gasoline supplies in the short-term until the higher refinery utilization rates can be restored.

In the face of these market factors, the NYMEX system continues to work according to design. As intended, NYMEX's highly transparent, open and competitive market place adds a level of economic stability to the situation by providing a reliable and well-regulated price discovery and risk management forum.

SURVEILLANCE

NYMEX has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing on whether the futures markets are converging with the spot physical market as the NYMEX contract nears expiration. Large trader data are reviewed daily to monitor customer positions in the market. At the end of every trading day, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels. These data, among other things, are used to identify position concentrations requiring further review and focus by Exchange staff. Any questionable market activity results in an inquiry or formal investigation. By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are

set at a level that greatly restricts the opportunity to engage in possible manipulative activity on our markets.

NYMEX maintains a comprehensive audit trail of all transactions executed on the Exchange. The audit trail includes such data as trade time, executing broker, and the account number for the beneficial owner of the trade and other data, which can be used to reconstruct trading activity for investigative purposes.

In addition to the Exchange's self-regulatory program, the CFTC conducts ongoing surveillance of our markets, including monitoring positions of large traders, deliverable supplies and contract expirations. The CFTC also conducts routine rule enforcement reviews of our regulatory programs. NYMEX consistently has been deemed by the CFTC to maintain adequate regulatory programs and oversight, in compliance with its self-regulatory obligations under the Commodity Exchange Act.

SPECULATORS

It is widely, yet inaccurately, theorized that speculators can drive prices up. Placing blame on speculators may grab the attention of the media, but does not accurately reflect the realities of how markets work. With hundreds of commercial participants and instantaneous price dissemination, any "speculative" price would be met with an equally strong "commercial" reaction. If markets move in a direction inconsistent with actual market factors, a vast number of participants including energy producers, wholesalers, retailers, and government agencies have comparable access to information. These participants will respond to ensure that prices rapidly return to where the industry consensus believes they should be.

Speculators do exist and they actually play a valuable, even necessary role in the market. They add liquidity to the market and enable commercial traders to get in and out of the market when necessary. By the nature of their role, speculative traders seek to participate in price trends that are already underway, but because they lack the capacity to make or take delivery, they will never be in a position to hold a market position through to the delivery process. They create virtually no impact on daily settlement prices, the primary benchmark used by the marketplace.

The speculative participation in the NYMEX New York Harbor Gasoline Futures Contract continues to be relatively modest and essentially unchanged from levels observed a year ago. Our latest data from year-end 2005 (see Chart D, attached) show that speculators held 24% of the total open futures positions, up from 22% in the previous year. Meanwhile, commercial companies, which are actively hedging their physical gasoline transactions, account for the majority of the futures market participation with 76% of the total open interest. Open interest represents the total number of futures contracts that are currently held by buyers and sellers, and this measure of market participation is monitored by the Exchange and reported to the CFTC on a daily basis.

CONCLUSION

At all times during periods of extreme uncertainty in the market, NYMEX has been the source for transparent prices in the energy markets. Our price reporting systems, which provide information to the world's vendors, have worked flawlessly and without delay.

The NYMEX marketplace continues to perform its responsibility to provide regulated forums that ensure open, competitive and transparent energy pricing. We can

only imagine the market uncertainty and further devastation to consumers if NYMEX were unable to perform its duty and prices were determined behind closed doors.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions members of the Committee may have.